

MEASURING PERFORMANCE IN DIFFICULT TIMES

With the business world experiencing the coldest economic winds for a generation, it is important for the finance department to focus on the measurements that matter. But which are they? Here **David Parmenter** offers a guide.

With the economy in downturn and many businesses facing challenging times, we should be measuring business performance in a new way.

Our traditional tools and processes for performance measurement are more akin to Charles Dickens than the 21st century, and thus more appropriate for the Victoria and Albert Museum than a fast and flexible organisation. We need to look at what we can do immediately and the changes we need to work on in the next six months.

Immediate changes

The finance team has to become a partner in your organisation's survival which will mean reducing time in many of the numbing activities which 'lock us up' producing reports, too late and of little value.

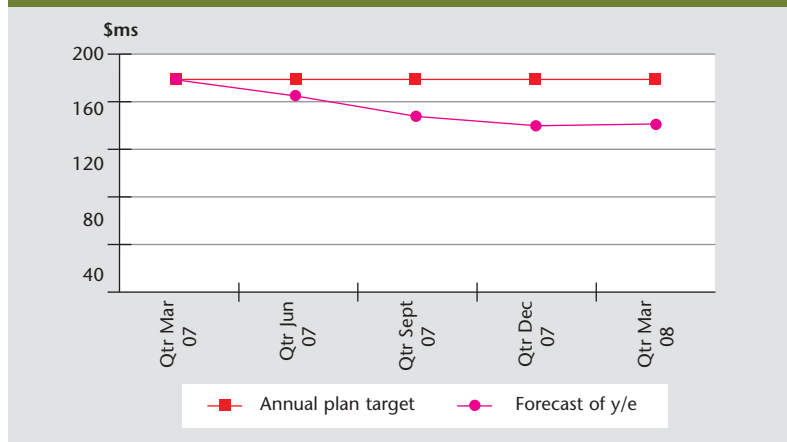
Producing meaningful weekly snapshots and dashboards instead of numbing monthly financial reports

Many management reports are not management tools; they are merely memoranda of information. Too many of our reports are issued well after the horse has bolted, eg monthly. They should encourage timely action in the right direction, by reporting on those activities the board, the management and the staff need to focus on.

Many monthly finance reports, prepared by the finance team, are never read. They include endless detail, often a result of having a common template for all subsidiaries, regardless of size. The result is a consolidated pack with a four to five page essay, consolidated numbers and a copy of each subsidiary's submission. I once saw a 140 page pack!

We need to reduce the finance pack down to under ten pages. Eliminate the essay and simply have a small comments box on each statement. Only have one page to summarise the subsidiaries' results and only include the large ones and any others that are in trouble. Small subsidiaries that are performing well do not need to be included in the pack. This pack should be read within three working days of month-end, a feat that is achievable in every company I have ever seen. Leading organisations are either reporting by day one or have adopted full profit reporting any time in the month.

Figure 1 EXTENT OF PERFORMANCE GAP



For leading organisations, decision taking is based around daily/weekly information on progress within the organisation's critical success factors (CSFs). In one company the senior management team (SMT) has a 9am news report every morning followed by further weekly information – so that at the monthly management meeting, even the HR manager is able to enter the sweepstake guessing the month-end result.

As a corporate accountant, you have arrived when your management team intuitively knows whether the month is a good or bad one, during that month. This knowledge enables it to do something about lifting performance, if necessary.

In these times of violent change, the finance department should look at providing the following daily and weekly reporting:

- a day's sales reported by 9am the following day;
- transactions with key customers reported weekly;
- weekly reporting on late projects and late reports;
- reporting some weekly information on key direct costs; and
- daily/weekly reporting on key performance indicators (KPIs).

Forecasting – telling management what they need to know rather than what they want to hear

Boards and the senior management team have often been confused between setting stretch targets and a planning process. Planning should always be related to reality. The board may want a 20% growth in net profit, yet management may see that only 10% is achievable with existing capacity constraints. The board then needs to make strategic decisions to manage the shortfall. The board has every right to decide that the stretch target is the basis for the bonus.

In these turbulent times the separation of targets and realistic forecasts is fundamental and a survival necessity. It is vital that the forecasting process generates realistic forecasts rather than forecasts that the board or senior management want to achieve.

The board will want to monitor the extent of the performance gap and this can be easily shown in a graph, see Figure 1, above.

Typically finance has, monthly, reforecast the year-end numbers each month. But why should one bad or good month change the year-end position? We gain and lose major customers, key products rise and wane, this is the life cycle we have witnessed many times.

Important structural changes to implement in the next six months

This climate offers a perfect time to make radical 'legacy' changes to performance management. My recommendations are as follows.

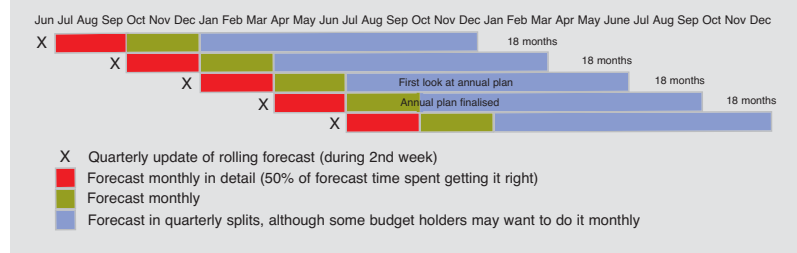
Replace the annual planning process

The annual planning process is not adding value. Instead it is undermining the efficient allocation of resources. As a process, it encourages dysfunctional budget holder behaviour, negating the value of monthly variance reporting and consuming huge resources from the board, senior management team, budget holders, and of course the finance team.



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Figure 2 THE ROLLING PROCESS



In these times of rapid change current annual plans, finished in the last year, are meaningless. They did not foresee this recession, and we will never be able to second guess the extent of this recession for the next annual plan either.

The corporate accountant needs to set up a quarterly rolling planning regime to set better targets in these challenging times:

- reporting targets for the next quarter, only one quarter ahead;
- funds budget holders on what they need one quarter ahead; and
- a quarterly update, bottom-up, of the year-end and beyond position.

So what is a quarterly rolling planning process?

The quarterly forecasting process is where management sets out the expected revenues and expenditures for the next 18 months, updated two to three weeks before the next quarter starts.

While firming up the short-term numbers for the next three months, the process also updates the annual forecast and views the bigger picture six quarters out. See Figure 2, above for the rolling nature of the process for organisations with a March, June, September or December year-end.

Budget holders are encouraged to spend at least half their time getting the detail of the next three months right as these will become the new reporting targets. Each quarter forecast is never a cold start as they have reviewed the forthcoming quarter a number of times.

Provided you have an appropriate forecasting software management this activity can be done very quickly. One airline even does this in three days! The overall elapsed time of the four forecasts, in a year, is as little as five weeks. Compare this to your annual planning cycle that on average takes eight to 12 weeks.

The key points of a quarterly rolling planning process are:

- budget holders provide an annual plan through the bottom-up quarterly rolling forecasting regime but are

not assigned those funds, this is done on a quarterly-by-quarter funding. We say to a budget holder we will be aware of your annual request but will only fund you on what you need to run the next quarter;

- the spend-it or loose-it mentality is no longer incentivised. Budget holders will be weaned-off asking for annual entitlements they do not need or may not need as they know what's the point of participating in 'annual plan game playing' when the real action occurs once a quarter, just before the new quarter starts;
- budget holders find it nearly impossible to hide their reserves in the next three month period, so they will only be funded with what they need;
- budget holders are encouraged to seek funding for initiatives that were not in the annual plan, as long as they have a sound fit with the organisation's strategic objectives;
- monthly reporting is more meaningful as it measures performance against the most recent forecast and not a monthly split of the original annual plan;
- while each subsequent forecast is still expected to put the ball through the expected 'annual plan' goal posts it is not forced to do so – we would rather have the truth than have an unattainable result of what the senior management want to see; and
- forecasting is carried out on an appropriate planning tool that can handle a bottom-up forecast once a quarter - Excel is not, and has never been, an appropriate tool for a key company system.

If you cannot replace the annual plan in six months you can:

- avoid breaking down the annual plan target into 12 before the year starts – as accountants we like things to balance. Thus it appeared logical to break the annual plan down into 12 monthly breaks before the year had started. We could have been more flexible. Instead we created a reporting yardstick that undermined our value to the organisation. Every month we make management, all around the organisation, write variance analysis – 'it is a timing difference....' 'we were not expecting this to happen', 'the market conditions have changed radically since the Plan' etc. This problem is going to be accentuated in these turbulent times; or

AN ESSENTIAL TASK – ESTABLISHING A COMPANY'S 'TRUE' KPIs

From my research, very few organisations really monitor their true KPIs. The reason is that very few companies, business leaders, writers, accountants, consultants have explored what a KPI actually is. From the extensive analysis I have performed and as a by-product of the years writing a KPI book I have come to the conclusion that there are four types of performance measure. These were discussed in an article published in *Finance & Management* May 2006. The four measures are:

- key result indicators (KRIs) – these give an overview on past performance and are ideal for the board as they communicate how management has done from a critical success factor or balanced scorecard perspective, eg return on capital employed;
- performance indicators (PIs) – these tell staff and management what to do, eg deliveries-in-full-on-time to customers;
- result indicators (RIs) – these tell staff what they have done, and all financial measures are a RI as they have quantified activities, eg, daily sales by major product and branch and weekly sales to key customers; and
- key performance indicators (KPIs) – these tell staff and management what to do to increase performance

dramatically, and are all non financial as they focus on the activities you want more or less of, eg late or incomplete deliveries to key customers, notified to CEO by 9am the next day.

Thus we need to separate out all the measures we are using and slot them into their respective type. In these times, KPIs, which are non financial measures, will be something like:

- late/incomplete/rejected deliveries to key customers – ensuring that the dispatch department focuses on the important deliveries, and gets these right first time;
- innovations adopted this week – an important measure to help focus busy teams to avoid simply being caught in the 'catch 22';
- weekly sales to major customers – we will need to monitor closely the drop off of interest in products much earlier on in this climate;
- near misses and other breaches of health and safety – as important as ever and need to be reviewed daily;
- date of launch of new product/service - this needs to be reviewed weekly as the sales management team may need to bring forward the launch to combat a drop in sales in the 'cash cow' products;

- weekly list of late projects, late reports so management are aware there is no place to hid for non- delivery or poor performance;
- weekly measure of the incidents where staff have showed their use of empowerment – important to ensure the organisation is growing into a fast and flexible organisation;
- weekly cashflow statistics for the next 30, 30-60, 60-90 days – needed to focus on the high risk periods;
- monthly review of initiatives planned next three months, next four to six months, next seven to nine months to enhance attraction to company by future staff, and future customers. You only need to see how the Virgin group have scored so well in this area particularly with the promotional activities of Sir Richard Branson;
- monthly, measure of the number of activities undertaken to implement staff suggestions;
- monthly, measure of staff initiatives that are to be implemented in the next month, months two and three; and
- initiatives to streamline performance related pay - this needs to be monitored monthly until the new regime is embedded.

- avoid giving the budget holders an annual entitlement – giving them an 'annual entitlement' to funding is the worst form of management we, as accountants, have ever presided over. I use portioning out a birthday cake at a nine year old's party to explain the stupidity of an annual plan. A clever parent says to party goers, "Here is the first slice, if you finish that slice and want more, I will give you a second slice". What we do in the annual planning process is divide the cake up and portion all of it to the budget holders. Like nine year olds, budget holders lick the edges of their cake so even if they do not need all of it nobody else can have it. Why not, like the clever care giver, give the manager what they need for the first three months, and then say "what do you need for the next three months" and so on. Each time we can apportion the amount that is appropriate for the current conditions.

The extermination of the annual plan was first written about by Jeremy Hope of 'beyond budgeting' fame. Read his *Reinventing the CFO: How Financial Managers Can Transform Their Roles and Add Greater Value* (Harvard Business School Press, 2006).

Critical success factors (CSFs) need revisiting in these challenging times

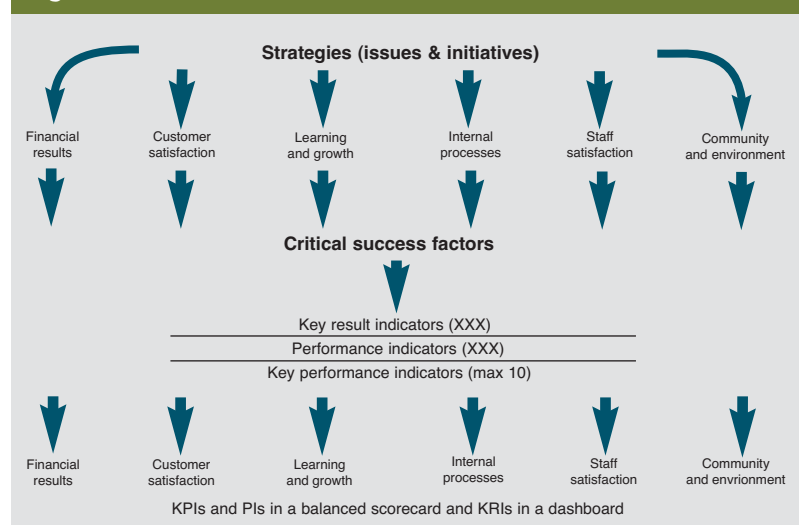
Understanding, measuring and managing critical success factors, is increasingly important to ensuring the survival and future prosperity of organisations. Most organisations know their success factors, however few organisations have:

- worded their success factors appropriately;
- segregated out success factors from their strategic objectives;
- sifted through the success factors to find their critical ones – their CSFs; and
- communicated the CSFs to staff.

It is the CSFs, and the performance measures within them, that link daily activities to the organisation's strategies.

If your organisation does not know its' CSFs performance measurement will be a random process creating an army of measurers producing numerous numbing reports, and which often 'measure' progress in a direction very remote from the intended strategic

Figure 3 MISSION – VISION – VALUES



direction of the organisation. Pareto's rule most certainly applies here, ie 20% of the reports meet 80% of management's need.

CSFs are the 'list of issues or aspects of organisational performance that determine ongoing health, vitality and well-being', according to AusIndustry, the Australian Government's division supporting industry, research and innovation. Better practice suggests that organisational CSFs should be limited to between five and eight regardless of the organisation's size. However, for a conglomerate the CSFs will largely be industry specific, eg the CSFs for an airline are different from those of a retail record chain store. Thus there would be a collection of CSFs in the conglomerate greater than the suggested five to eight.

The relationship between CSFs and KPIs is vital, as illustrated in Figure 3, above. If you get the CSFs right it is very easy to find your winning KPIs – eg once the 'timely arrival and departure of planes' CSF was identified it was relatively easy to find the KPI – 'planes over two hours late' for a well-known airline.

Some relevant success factors for these turbulent times:

- supporting local businesses (% of purchases to have local content);
- delivery in full on time, all the time to our key customers;
- prioritising all activities that will free up cash;
- finding better ways to do the things we do every day;
- maintaining a safe, happy and healthy workplace;
- innovative ideas from staff encouraged and adopted quickly;
- finishing what we start;
- only starting value adding projects;
- selling a greater share of our profitable products to our key customers;
- increased repeat business from key customers;
- our customers being active advocates for our business (especially our key ones);
- increasing adaptability and flexibility of staff;
- attracting quality staff to the organisation;
- "stay, say, strive" engagement with staff; and

- appropriate reward and recognition structure for all staff.

There are a number of characteristics of critical success factors which are worth dwelling on:

- they will be 'no surprise' to management and board as they will have talked about them as a success factor;
- their influence cuts across a number of BSC perspectives (eg the timely arrival and departure of planes impacts nearly all the BSC perspectives of an airline);
- they have a positive influence on the organisation;
- they have a great influence on other success factors; and
- are focused in a precise area, rather than being a bland statement so often characterised by strategic objectives – examples of unhelpful bland statements are 'increased profitability', 'cost reduction', 'maximising the use of our most important resource - our people'.

Growth targets will need to be set more sensibly

Every day now we see yet another merger born out of desperation, opportunism or sheer stupidity. Not one board member, CEO or shareholder who has studied the evidence on takeover or mergers, based around a cost saving or defensive strategy will go into such activity lightly. One in six break even – the rest fail, bringing down shareholders' wealth 18-24 months after the merger.

The growth objectives of many boards would naturally lead one to the conclusion that only when there was one monolith left would they be happy. They ignore the reality that there is an optimal size of an organisation based around the competence of management, the nature of the industry, the culture of the organisation and the regulatory authority perception.

WHAT YOU SHOULD BE MEASURING – AND WHY

In this economic climate and the subsequent recovery boards hopefully will look for organic growth rather than attempt the ‘herding of cats’ which is so commonly a merger activity.

Performance related pay needs reworking

Performance related pay has been a much understudied area. In addition, too many examples exist of different departments or individuals having conflicting bonus related targets that create an atmosphere of distrust and unhealthy conflict within an organisation. In many cases the individuals approving performance related pay deals had an interest in them being simplistic and flawed as they themselves wanted a similar structured deal.

Human resource management practitioners, I believe, have not been vocal enough in explaining to senior management and the board that remuneration is not the key motivational force.

Thus with a combination of naivety, invested interest, and competitive pressures performance related pay was doomed to fail the company and the shareholder. Vast portions of performance related pay are paid over to the employees with no relationship to the extent they have grown the market share, the risks of a downside around the corner, and the longevity of the market share price increase.

Next steps

I am talking about a lot of change. We need therefore to sell the new vision, and commence on a programme constructing a few wins early on:

- to understand the changes involved listen to my free webcasts on www.bettermanagement.com as I have explained ‘quarterly rolling planning’, ‘how you convert your reports to a decision based tool’ ‘how to report month-end in three working days or less’ and ‘how to find your critical success factors’;
- share this article with some like minded people on the SMT and board, and working through them prepare a presentation, ‘selling the change’; and
- before you present ensure you have bounced off your approach with a public relations expert as they are the experts on the emotional drivers required to sell the change in your organisation. ■



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The previous article gives a KPI consultant’s view of what businesses should be measuring in tough times. Here and on the next two pages, some of those at the financial sharp end, in a variety of industries, explain what they are measuring most closely now – and the reasoning behind their choices, while Philip Smith, on page 13, shows how a weekly reporting system can help a business keep right up to date on profit trends.

MONITOR OPPORTUNITIES

Despite a number of business closures in Australia in recent months, so far the demand for Hydro Tasmania’s main product, energy, has not decreased significantly. However there are two key risks that may affect this in the future:

- many companies are reviewing expansion plans and so their energy requirements may plateau; and
- commodity-based industries, such as aluminium producers, are seeing reduced prices for their products and reductions in demand, leading to the possibility that their energy requirements could fall.

Like many other businesses, Hydro Tasmania is focusing on monitoring its credit exposure closely in these uncertain times. However it is also keeping a close eye on associated third parties, addressing such questions as:

- What is the trend in demand? (Demand figures need to be reviewed and reforecast, particularly due to the increased risk of businesses reducing demand or leaving this business area altogether.)
- Are any customers or suppliers experiencing refinancing problems?
- Will counterparties to energy contracts be able to deliver?
- What are the risk ratings of institutions providing clearing services for futures markets? (Hydro Tasmania is looking to diversify this risk.)

On the other hand, new opportunities also need to be monitored. There may be the chance to buy assets and businesses from distressed sellers at favourable prices.

As you might expect, given our area of activity, Hydro Tasmania has not reduced its attention to sustainable measures. However there is now certainly an increased focus on business sustainability itself. ■

It would be myopic to look only at present cost management without considering future business and revenue



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CUT JOBS ONLY AS A LAST RESORT

In times of financial turmoil, the professional demands on finance people are extraordinary. In my 31 years of professional experience, the current crisis is by far the worst and, in today's connected world, no organisation – and, indeed, almost no-one – is being spared.

Tough times call for tough decisions and a whole new way of looking at things. Previously adopted KPIs and performance measurement indices must now be reviewed for relevance and applicability.

For example, stringent controls over credit must be applied and debtor analysis and review of debts' ageing (ie how collectible those debts are) must be done almost daily. Previously creditworthy customers may now face a cash crunch. Inventory holding levels, whilst previously acceptable, may suddenly become bloated under present day circumstances. New strategies will have to be adopted to clear these excess inventories. Feedback through reports and frequent action-oriented meetings is now a necessity.

I was previously the CFO of Sincere Watch Limited, one of Asia's largest retailers of luxury timepieces with listed companies in Singapore and Hong Kong, and the moment the financial crisis hit us, the entire management, led by the finance team, went into crisis mode. As a great believer in balance sheet management, keeping a strong set of financials even in good times is an absolute 'must' for me. Cash flow and inventory are our lifeblood, so constant monitoring is essential. Even more urgent is the need to enhance the important line of communication with our bankers during crisis.

Although cost cutting measures are a given, it would be myopic to look only at present cost management without considering future businesses and revenue. For example, laying off staff is, unfortunately, one of the easiest recommendations finance can make to cut costs. However, retrenchment must be a last resort - and even then only after very extensive and judicious consideration. I have seen too many poorly conceived retrenchment exercises undertaken by companies to know that these very same companies will be faced with inadequate manpower resources to take on new opportunities when the economy recovers. ■



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CONSIDER NON-STANDARD KPIS

In our business we use the usual post hoc accounting measures. However there is a need – especially in the current climate – to look at 'real time' issues and what you might call 'external' KPIs, especially if you are borrowing money and have credit lines. Below, I describe some of the quirky non-standard KPIs which have proved helpful for us.

Business drivers

Understanding, and concentrating on, the key non-financial business drivers – eg for us, these include number of retail outlets, fleet size, rental per unit per day, etc – automatically transfers into sales as well as helping in managing direct (variable) costs.

Costs

'Variable-ising' as many fixed costs as possible and taking on pay-as-you-use products rather than any

fixed costs unrelated to volumes, means that KPIs can then all be related as percentages of sales. Low operational gearing is in itself an important KPI

Working capital

Tracking debtor days and constantly reviewing credit limits – quite often setting credit limits on outstanding (as yet unbilled) orders as well as invoiced sales – helps with working capital. Daily cash balance reporting and expressing the headroom available in credit lines in percentage terms also help us see the picture. So, too, does keeping track of the percentage of creditors outside payment terms.

Credit scoring

Managing the public credit scoring ratios such as average days to pay, ensuring that you are seen as a good credit risk, helps retain the confidence of your creditors. (In the bigger companies this will also involve keeping a good credit agency rating.. ■

SALES, CASH, CASH



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We have not changed our chosen performance measures, but the focus on them has definitely intensified and we have increased the frequency with which we report on them.

Sales orders and shipments are looked at daily, as there is much less visibility in our current marketplace. Key economic variables – exchange rates and polymer costs are showing more volatility than in recent years. Measurement of contribution margin and discretionary spend is more frequent.

However, the key measures are those on cash - stock turns, stock over six months old, overdue debts and net cash/debt balances. These are particularly important in the current economic environment.

The measures which are used in an economic downturn are no different from the measures that a well-run business will be looking at anyway. What is different is their importance. The risks and margin for error are far greater now than in more buoyant times and better attention and quicker reactions to adverse trends are required.

This downturn differs from previous ones I have known in that I have never before seen the banking sector going into a downturn in such a weak state. This makes all the measures concerning cash crucial at the moment. It also means thinking of potential indirect effects – such as how secure your customers, suppliers and other relationships are (given that no company operates in a vacuum). ■

REPLACE MONTHLIES WITH WEEKLIES



Faculty committee member **Philip Smith**, a profit improvement specialist, uses weekly accounts as the main information system. Here he describes the real-life example of a system he implemented for a medium sized company.

The company

A logistics company with sales of £38m, a staff of 500, and 30 profit centres, whose business is based on customer contracts.

The system

Detailed weekly profitability reports, compared to target, are reported by the 30 profit centres, and consolidated into a company total, by Wednesday of the following week. Data is gathered, as incurred, from the company's operational IT systems as follows:

- revenue - daily as each job is done;
- variable costs (eg subcontractors, agency staff) from the purchase order system or other specific systems (eg wages, fuel);
- fixed costs (eg salaries, depreciation) from allocations to profit centres; and
- all reports are referenced to nominal ledger codes, for validation later to invoices.

Targets are produced by profit centres at the start of each quarter (13 weeks), by projecting current norms, adjusted for known changes and profit improvement actions.

How it is used

The system provides the main internal reporting measure. Where it reports significant variances versus target, management drills down to identify whether these signify a blip or a trend, and the underlying operational cause. If a negative trend is found, profit improvement actions are initiated

Traditional monthly accounts revert to a support role, validating the weeklies via reconciliation at nominal ledger code level, and providing formal reporting to banks and shareholders. KPIs become support indicators in a similar manner.

Benefits

The benefits include:

- company-wide focus on profitability;
- immediate highlighting of negative trends by profit driver, triggering quick implementation and monitoring of remedial actions;
- a real understanding of profit drivers, by directly linking operational actions to profitability, fitting the weekly operating cycle;
- no lagged reporting, and consistent cycle (unlike with uneven calendar months); and
- monthly accounts routines focus on financial control and validity, not speed of production.

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